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MINORITY VIEWS ON MONETARY POLICY, 1985

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

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[illegible]

December 16, 1985

Hon. Fernand J. St Germain
Chairman, House Committee on Banking,
Finance, and Urban Affairs
2129 Rayburn House Office Building
Washington D.C., 20515

Dear Mr. Chairman:

I am pleased to transmit a report of the Republican Members on the Federal Reserve's conduct of monetary policy and related issues of current concern.

The considerations detailed in this report pick up from the mid-year hearings on monetary policy and cover events and issues relating to monetary policy through November. An assessment of the Federal Reserve's money supply targets for 1986 is also provided in preparation for the Humphrey/Hawkins hearings in February of next year.

These are the reasons for the separate report by the Committee's Republicans at this time:

1. The Committee Print published by the Domestic Monetary Policy Subcommittee following the mid-year hearings purported to reflect the views of its Members on monetary policy. It not only made this claim on the title page, it continued to confirm that impression in its conclusions by statements such as: "The Subcommittee believes...the Subcommitee agrees..." The fact of the matter is that the only Members' names associated with the alleged Subcommittee Report were those of Chairman Walter Fauntroy who signed the letter of transmittal and Congressman Stephen L. Neal who attached his "Additional Views". We cannot help but feel that the publication of this report in the format chosen represents an arrogation of responsibility for Members' views on monetary policy that is totally unwarranted.

2. A major reason for this occurrence undoubtedly is the failure of the Subcommittee staff to allow Members and their staffs

sufficient time to study the draft and form a considered opinion whether to support it or provide dissenting views. Congressman Neal said it well: "Members are given only a few days to digest and respond to a report which took the Subcommittee staff two months to prepare."

3. The actions undertaken by the Administration to lower the exchange rate of the dollar, Congressional action to arrest the growth of the federal debt, and Secretary Baker's initiatives in the international debt area, make a reappraisal of monetary policy and its significance for the success of these undertakings a timely endevor.

Sincerely,

Bill McCollum, M.C.
Ranking Minority Member
Subcommittee on Domestic
Monetary Policy

CHALMERS P. WYLIE

NORMAN D. SHUMWAY

STAN PARRIS

BILL MC COLLUM

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JIM KOLBE

MINORITY VIEWS ON THE CONDUCT OF MONETARY POLICY, 1985
BY REPUBLICAN MEMBERS OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

INTRODUCTION

The following is our assessment of monetary policy and related issues beginning with the midyear testimony presented by Chairman Volcker and other witnesses* before the Subcommittee on Domestic Monetary Policy. The hearings were held on July 17th and 18th, 1985, pursuant to the provisions of the Humphrey/Hawkins Act. Our present comments cover policy and monetary developments from that date forward through the end of November. While we do not agree with every point made in these Minority Views, we support the general thrust of the message and conclusions.

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*These additional witnesses included Dr. Nancy Teeters of IBM (formerly a Governor of the Federal Reserve Board), Dr. Allan Sinai of Shearson Lehman Brothers, Dr. Lawrence Chimerine of Chase Econometrics, Dr. Michael Sumichrast of the National Association of Home Builders, and Dr. Norman Robertson of the Mellon Bank.

SUMMARY AND CONCLUSIONS

* Monetary policy cannot be considered in a vacuum. It must be evaluated in the context of the federal budget deficit on the one hand and the trade deficit on the other because of its strategic importance for interest and foreign exchange rates.

* Republican Members of the Committee on Banking, Finance and Urban Affairs feel that money supply growth during the past year - while generous - has not been excessive when all the monetary aggregates are considered and when the behavior of prices, interest rates, and the nominal GNP are taken into account. Significant monetary restraint is, therefore, not indicated at this time.

* Mindful of the Administration's effort to deal simultaneously with our fiscal and trade problems, we feel that significant monetary restraint is not required for this reason.

* Should the expansion of our economy proceed in 1986 at a rate substantially above that assumed by the Federal Reserve, then the monetary authority should restrain money growth to avoid inflation regardless of other policy consideration.

* In the contrary event of a cyclical downturn, the Federal Reserve should not attempt to fine-tune nominal GNP in an effort to head off that kind of adjustment. Anticyclical policy is the primary responsibility of the Administration and Congress.

- The September agreement of the G-5 nations in New York was a step in the right direction undertaken at the right time as part of an international effort to realign key currencies including particularly the U.S. dollar, provided, however, this does not compromise the credibility and flexibility of the Federal Reserve to conduct monetary policy so as to ensure domestic price stability.

- Finally, we agree that our foreign trade deficit - and the high value of the dollar - is ultimately brought about by large net capital imports which are attracted here by differentials in real interest rates and other earnings opportunities. The objective of achieving a better balance in our foreign trade accounts, therefore, ultimately calls for a progressive reduction in the federal deficit and a less expansionary budget. This is a task for the Congress and the Administration. Monetary policy aimed at exchange rates - a symptom rather than a cause - is of limited usefulness.

THE MIDYEAR HEARINGS ON MONETARY POLICY

In his prepared remarks Federal Reserve Board Chairman Paul Volcker described the (then) current state of the economy as one of "slower, and more lopsided, growth in economic output." He added that while the goods producing sectors of the economy were laggard, domestic demand was expanding at a relatively brisk rate. The disparity between growth in demand and output he ascribed to the fact

that much of domestic demand was being met by growing imports which, in turn, were reflected in the large balance of trade deficit.

Against a background of relatively low growth in output and (historically) high unemployment, low rates of inflation and well contained cost pressures, the Federal Reserve felt it was desirable to accommodate financial markets by supplying reserves to the banking system. This policy encouraged lower interest rates and a sharp increase in M1, the narrowly defined money supply. The fact that the broader measures of money supply growth - M2 and M3 - stayed close to the upper limits of their respective target ranges suggested that factors additional to monetary ease were at work in bringing about the rapid rise in M1. Chairman Volcker surmised that individuals and businesses tend to build up liquid balances when interest rates decline and when the sacrifice of foregone interest income is, therefore, diminished. Moreover, earnings opportunities now exist on certain M1-type balances (whose exclusion from the data would show M1 to have had a markedly slower growth rate) and the danger of inflationary erosion of their purchasing power has receded. This interpretation of the facts - in combination with slow growth of the economy during the first half of 1985 - presumably prompted the FOMC to let M1 rise well above the upper limit of the target range. Similar considerations, no doubt, explained the Federal Reserve's decision to rebase the target range of M1 on the second calendar quarter for the remainder of this year and to broaden the limits of the target range to 3% - 8% (from 4% - 7%). The 1985 target ranges for M2 and M3 remained unchanged.

As regards the tentative monetary targets for 1986, M1 is slated to revert to its initial 1985 range, M2 remains unchanged at 6% - 9%,

and M3's upper limit is shaved half a point to 6½ - 9½, the same as M2, therefore. The target range for domestic non-financial debt is tightened by reducing it by one full point at the upper and lower limit, i.e., to an 8% - 11% growth range during 1986.

The monetary targets for 1986 are consistent with an economic outlook for that year (central tendency of all polled FOMC members) which is characterized by real GNP growth of 2.75% - 3.0%, inflation of 3.75% - 4.0%, and unemployment of 7.0% - 7.25%. These economic assumptions for the coming year appear close to the probable actuals for 1985.

More important than this set of numbers is the rationale on which they are based and the policy recommendations which Chairman Volcker presented to the Committee at this time.

In substance he argued that "...monetary policy has accommodated a sizable increase in monetary and credit growth and interest rates have dropped appreciably... . In that way economic growth has been supported at a time when the dollar has been particularly strong and inflationary pressures quiescent... . But there are obvious limitations to the process of monetary expansion without threatening the necessary progress towards stability upon which so much rests." He urged that the only way out at this juncture is for Congress and the Administration to deal effectively with the budget deficit. In addition, he pleaded that other nations, particularly our industrialized trading partners, do more to open markets, deal with their structural rigidities, and encourage growth - in other words, stimulate "a home grown expansion", as he put it.

The following day's witnesses corroborated Chairman Volcker's views both as regards the (then) current state of the economy and in

respect to policy recommendations. They were particularly concerned by the dilemma faced by the Federal Reserve's policymakers and the narrowing of their options. Dr. Robertson, for example, after raising the question "whether the Federal Reserve should endeavor to reinvigorate a cyclical expansion which has already dissipated much of its energy", concluded that a more stimulative policy might well accelerate the dollar's decline and thereby put upward pressure on prices and interest rates. Whereas, on the other hand, restraint and a consequent slowing of the U.S. economy would pose great dangers for the rest of the world and "...there is little doubt that the international debt problem would quickly return to a 'crisis' status." Drs. Chimerine and Sinai pointed to the same kind of dilemma, all of them concluding that an early and effective attack on our federal deficit was the only answer.

ECONOMIC UPDATE THROUGH NOVEMBER

After a lapse of some four months, the conclusions of the Subcommittee's witnesses regarding the condition of and the outlook for the economy remain largely valid. As we now know, real growth of the economy increased to 3.0% during the third quarter from an anemic 1.1% growth during the second quarter of the year. Unemployment, having appeared riveted to a 7.3% rate for six consecutive months, dropped to 7.0% of the civilian labor force in August and then hovered just above 7.0% during September-November. The index of industrial production showed little change during recent months and the capacity utilization ratio held steady at just above 80%. Considering the lower level of interest and mortgage rates, new

housing construction showed less than the expected vigor and business fixed investment held steady. Significant changes occurred, however, in the foreign exchange rate of the dollar which declined further since midyear 1985 and by now has receded almost 23% from the high reached in late February of that year. In August the balance of trade showed a nominal improvement over July, and then rose to a (revised) deficit of $11.5 billion in September and $11.8 billion in October. Adding in services, the balance on current account still looks like a negative $125 billion for the year. In sum, the economy appears delicately balanced between elements of strengtn which should sustain the current moderate upswing well into 1986 and elements of weakness which at best signal a slow and lopsided expansion during 1986.

NO CHANGE IN POLICY ISSUES

At the same time policy issues have moved into sharper focus, although the basic problems are still with us. Chairman Volcker summarized them well during his July 17th testimony:

- we are borrowing far more than we are willing to save internally;
- we are buying abroad much more than we are able to sell;
- we are piling up debts abroad to support our spending habits;
- key trading partners, despite their high exports to us, remain troubled by high levels of unemployment;
- our high levels of consumption and employment are not

matched by corresponding expansion of our industrial base; and

* after two and one half years of expansion, too many borrowers at home and abroad are under strain or are overextended.

Chairman Volcker rightly observed that many of these problems are outside the reach of monetary policy or even beyond the reach of economic policy by the United States alone. All that the money managers feel they can and should do at this time is to pursue a policy of moderate ease sufficient to facilitate the forward momentum of the economy and encourage stable or lower interest rates without creating expectations or conditions that would reignite inflationary pressures. We take that to be the intent of the FOMC based both on the testimony of its Chairman as well as the thrust of the discussions contained in its Record of Policy Actions. The grand strategy apparently is to gain time and provide the background conditions to permit policy initiatives by others, notably the Congress and the Administration - but also by the governments of our key trading partners - to deal with the kind of problems which Chairman Volcker listed in his testimony.

AMBIGUOUS SIGNALS

An assessment of monetary policy and the potential contributions to the resolution of these issues by the Federal Reserve is complicated by the fact that - as once before in 1982 - the traditional chief measure of money supply growth has been emitting ambiguous signals: while the money stock defined by M1 grew rapidly

since the fourth quarter of 1984, its turnover - its velocity in other words - has been diminishing since then rather than increasing at its long-term rate of somewhat over 3% per annum. The result is at least a partial offset. Thus, the expansionary effect of the 12.5% growth of M1 on the economy during this period is not clear. Neither are the reasons for the unusual behavior of M1 velocity.

During his testimony Chairman Volcker ventured these comments on the subject:

> "Against the background of a high dollar, the sluggishness of manufacturing output, and relatively well contained price pressures, quick and strong action to curtail the recent burst in M1 growth has not been appropriate.... we simply do not have enough experience with the new institutional framework surrounding M1 ... to specify with any precision what new trend in velocity may be emerging.... Moreover, while the surge in M1, and the related drop in velocity can be traced at least in substantial part to the interest rate declines of the past year, the permanence of the change in velocity will depend on inflationary expectations and interest rates remaining subdued. For these reasons, the Committee has continued to take the view that ... developments with respect to M1 be judged against the background of the other aggregates (i.e., M2, M3, and non-financial debt) and evidence about the behavior of the economy, prices, and financial markets, domestic and international."

OTHER VIEWS

This view of money supply growth and the implied posture of accommodation is not shared by all monetary economists. There are some who are sincerely convinced that the rapid increase (of M1) will inevitably induce an eventual recurrence of inflation. One such group, the Shadow Open Market Committee, had this to say in its (most recent) policy statement of September 22 - 23, 1985: "...the trend rate of money growth is rising, reopening the prospect of another

round of inflation. Three of the main justifications for current monetary policy repeat old errors. One is that financial deregulation has distorted the monetary aggregates. A second claim is that indicators other than money growth do not signal inflationary pressures. The third is that faster money growth is needed to bring down the exchange rate and aid manufacturing." It concluded: "We urge the Federal Reserve to end the erratic swings in money growth and turn to a stable, non-inflationary growth path." Elsewhere in the statement it urged that the money stock be returned to a growth path of 5.5%, its preferred policy option being to do so promptly (rather than gradually) even "at the risk of a small recession now so as to avoid higher inflation and a bigger recession later." No reference was made in the statement to the deviant behavior of velocity as a possible consideration in judging the appropriate growth rate of the M1 money stock.

The issue between rigorous monetarists and the Federal Reserve has, therefore, been squarely joined. It is, however, impractical for Members of this Committee to deal fully with the merits of each of the contentions raised in this Report. Clearly it would be desirable to manage the monetary base so as to induce money supply growth at a steady - and preferably lower - rate, to the extent that this can be accomplished without unwanted declines in economic activity; equally desirable would be the stabilization of interest rates - although we suspect that the objectives of steady money growth and stable interest rates may at times be mutually inconsistent; and, of course, it would be helpful if monetary policy could be guided by a simple, constant, and well understood set of rules. We suspect, however, that financial markets are too often

subject to outside shocks and too often driven by ill-founded hopes and rumors not to require discretion by the money managers in the choice of variables that may help guide their decisions.

These issues have been debated for some time. But one issue that this Committee must come to grips with now - if it is to discharge its oversight responsibility - is the question whether or not current monetary policy has been and continues to be excessively accommodative and whether, therefore, the monetarist prescription should be followed.

WHAT THOSE VIEWS WOULD IMPLY

The recommendations of the Shadow Open Market Committee clearly imply a sharp turn towards monetary restraint - particularly if velocity continues at it present diminished rate. The most likely consequence of such renewed restraint would undoubtedly be a firming of interest rates in the context of continuing large budgetary deficits. The value of the dollar would rise again and our balance of trade would turn more negative. The rate of unemployment would increase as domestic consumption is met increasingly by foreign production. Under such conditions protectionist sentiment would undoubtedly strengthen further with possible serious consequences for world - and U.S. - trade, production and employment. The scenario outlined appears even more somber when consideration is given to the fact that (a) the present expansion phase is aging and is now entering upon its fourth year; (b) judging from the record of a growing number of mergers and bankruptcies, many of our financial institutions are in fragile condition; (c) serious financial problems

also afflict many farmers and farming communities; (d) consumers have assumed a heavy burden of repayments on outstanding loans and will have to cut back on new installment purchases if job security appears more precarious; and (e) the indebtedness of developing countries continues to be a serious problem and the service on that debt is made more difficult as interest rates rise and if demand for their exports flags as a result of trade barriers.

It is quite possible, therefore, that the "small recession" of which the Shadow Open Market Committee speaks may not be that small.

THE ADMINISTRATION STRATEGY

Not surprisingly, therefore, the Administration has preferred to support a different strategy which, if successful, holds out the hope of avoiding the deflation and possible recession that could well result from the monetarist prescription. This strategy involves three major initiatives: (1) target a balanced budget by a legislative commitment to an annual reduction in federal spending and deficits over a period of years to introduce a measure of continuing fiscal restraint; (2) orchestrate a reduction in the high value of the dollar in collaboration with the G-5 countries to help alleviate the imbalance in our foreign trade accounts; and (3) strengthen the role of the World Bank and arrange for a more constructive approach to the developing countries' debt problem by stressing growth rather than austerity.

Whether and to what extent these initiatives will prove successful remains to be seen, although the lack of attractive alternatives and the growing concern of the public make a resolution

of the problem along lines such as these a good possibility. Needless to say, a credible Congressional program of spending and annual deficit reductions should allow the Federal Reserve to pursue a policy that could be accommodative while being less concerned about raising inflationary expectations again.

Supplementing the decision to lower the dollar's exchange rate through joint central bank intervention, the G-5 agreement seeks to deal with the high dollar also by appropriate public policies - mainly fiscal and monetary in nature - among the respective trading partners. These policies are designed to modify the strength of international capital flows into the United States where they supplement inadequate domestic savings and thus help meet the borrowing needs of our Treasury as well as private capital requirements. It is of course these (net) capital inflows which have pushed up the exchange value of the dollar. Implementation of this part of the agreement would mean for the United States to allow interest rates to decline as the budget deficit is being reduced by cuts in outlays. Conversely, the other four countries, and particularly Japan, would pursue policies to stimulate their domestic economies by lowering taxes, liberalizing their financial markets, carrying out structural reforms, and taking other measures to promote domestic growth. They would also pursue a monetary policy that would not prevent interest rates from rising. All of these policies would be intended to improve investment opportunties and levels of consumption expenditures in the home markets of our main trading partners.

The G-5 agreement, to the extent that it is effective in modifying capital flows and lowering the exchange rate of the dollar,

is of great interest obviously to debtor countries that need to service their debts to the United States. While their dollar earnings from a given volume of exports to this country would rise, their export volume may well decline more than in proportion because of higher (U.S. landed) prices. Moreover, as the dollar declines all trading nations would face increased price competition by U.S. exporters in third markets. Although it is difficult to foretell without closer study the effect of a decline in dollar value on export earnings opportunities of specific debtor countries, it is quite likely that their financial problems will be made more difficult.

It is presumably with these or similar considerations in mind that Treasury Secretary James Baker presented the U.S. proposals for the future management of the developing countries' debt problem to the annual IMF/World Bank conference in Seoul.

CONCLUSIONS

Our first conclusion, which we belive is amply documented in the preceding discussion, is that monetary policy, its determinants and its consequences, does not stop at the water's edge. The domestic performance of our economy has become too closely linked to our performance in world markets and international finance ever again to be considered as a policy issue apart.

We further believe that the Federal Reserve should not at this time shift to a policy of significant restraint: partly because we give credence to the claim of the FOMC - the responsible policy makers - that monetary policy has not been and is currently not as

stimulative as maintained by some observers; partly because the Federal Reserve's monetary goals are consistent with economic forecasts for 1986 which still appear reasonable; partly because an economic strategy is being put in place by the Administration whose ultimate success depends in no small measure on a monetary climate that is sufficiently accommodative not to defeat the objectives being sought; namely, a better balance in our foreign accounts to the extent that this can be achieved through a devaluation of the dollar.

We also conclude that if the present expansion of our economy accelerates significantly above the levels assumed by the Federal Reserve and if prices rise at rates faster than those anticipated in the forecast - possibly as a lagged result of the Federal Reserve's policy of monetary ease since last year - then the monetary authority should adhere to its commitment to long term price stability by appropriate tightening of the money supply regardless of other policy considerations. The primary goal of Federal Reserve policy remains the best attainable economic growth subject to the maintenance of stable prices.

In the contrary case of a cyclical downturn, such as some observers expect in late 1986 or early 1987, the Federal Reserve should not attempt to fine-tune nominal GNP in an effort to head off that kind of adjustment. It would be our conclusion that in such event the Federal Reserve should assume a stance of moderate support to mitigate economic hardship but taking care not to lay up fuel for future inflation while standing ready to encourage the forces of expansion as soon as the adjustment has run its course. In this connection, we note that anticyclical policy is primarily the

responsibility of the Administration and the Congress.

We further conclude that the effort to reduce the dollar exchange rate by concerted central bank intervention - as agreed to by the September 22nd meeting of the G-5 nations - was worthwhile. Such interventions have usually not been successful in turning exchange rates contrary to basic market forces (other than smoothing exchange rate fluctuations). We do believe, however, that the decline in the dollar since late February 1985 indicates that changes in such basic market forces are in fact taking place. We, therefore, believe that the initiative by the G-5 nations has a good chance of achieving its objective, but only if the participants to the agreement follow through with appropriate fiscal and monetary policies designed to modify international capital flows.

We enter two reservations, however. First, the attraction of the United States as a repository of foreign savings rests in large measure on the perception of investors that the Federal Reserve has succeeded in and will continue to restrain inflation in this country. In this context it is well to remember that during 1977 to 1979 the United States intervened heavily in foreign exchange markets to halt the slide of the dollar - the very opposite of what we are trying to do now. The dollar stabilized only when the Federal Reserve adopted its new operating procedure in October 1979 which allowed it greater flexibility in U.S. interest rate and monetary managment and when it became apparent that inflation in this country was effectively being addressed. Accordingly, any constraint by legislative action on the Federal Reserve that would diminish its credibility in this respect could occasion rapid withdrawals of foreign savings and lead, among other things, to signifiant increases

in interest rates.

The second caveat is that a lower exchange value of the dollar not only will take time to permit the achievement of a more favorable trade balance - six to eighteen months is a common estimate - but also it is very likely to cause upward pressure on domestic prices and a corresponding monetary policy problem for the Federal Reserve. This is so because import prices rise as a result of the dollar devaluation as well as because domestic competitors will see an opportunity to improve their pricing and profitability. The transitional problems of the process to a better balance in our foreign accounts should, however, not lead us to give up on the effort by turning to a suicidal policy of protection.

We call attention to the fact that a lower exchange value of the dollar by itself does not guarantee an improved trade balance, unless U.S. exporters and import-competing domestic producers are quality-competitive, learn better to understand their foreign markets, and restrain themselves from converting their improved price competitiveness into offsetting increases in profits and wages.

Intervention in foreign exchange markets to lower the value of the dollar, properly understood, is treatment of a symptom. The underlying cause of our trade imbalance is large and persistent net capital inflows. These in turn are attracted in part - though not exclusively - by high real interest rates and earnings opportunities which are rooted in an expansionary federal budget deficit. It is the budget deficit which must be constrained responsibly, particularly as we increasingly become a net debtor to the world. This means that our foreign accounts not only will ultimately have to come into balance but that they must show a surplus if our foreign

debt is to be serviced.

The other half of the solution of our foreign accounts problem, we agree, is an encouragement of domestic investment and growth by our chief trading partners through policies that could well include increased fiscal stimulus.